

ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR A
HEARING TO DETERMINE THE FAIR VALUE OF
THE UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX A JUST
AND REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE SCHEDULES
DESIGNED TO DEVELOP SUCH RETURN.

Docket No. E-01345A-08-0172

Arizona Corporation Commission
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OPENING BRIEF OF

ARIZONA INVESTMENT COUNCIL

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1 The Arizona Investment Council ("AIC") files this Opening Brief on the Arizona Public
2 Service Company (the "Company" or "APS") Motion for Approval of Interim Rate dated June 6,
3 2008 (the "Interim Relief Request"). AIC urges the Commission to approve interim relief in the
4 amount of \$115 million.

5 INTRODUCTION

6 The Company currently has pending a permanent base rate request premised upon a test
7 year ending December 31, 2007. APS' permanent request is for slightly more than a \$278
8 million annual revenue increase, excluding the PSA revenues to be reclassified as base
9 revenues.¹ The Company's Interim Relief Request is for a \$115 million annual electric revenue
10 increase, subject to refund with interest pending the Commission's decision in the permanent rate
11 case.²

12 The Financial Meltdown 13 **BAILOUT UNRAVELS**³

14 When APS filed its Interim Relief Request on June 6, 2008, it was fully justified. APS
15 credit ratings are only one level above non-investment grade or "junk" status. Although it now
16 plans some construction expenditure reductions over the next three-year period,⁴ projected
17 construction outlays still total about \$800 million per year for the foreseeable future. As a result,
18 APS must secure some \$2 billion of financing from external capital sources over the next five
19 years. That means, of course, that APS must be able to go to the capital markets in order to
20 continue to provide safe, reliable and adequate electric service to Arizona. It must be able to
21 secure financing at a reasonable cost.

22 ¹ APS-1, p. 5, ll. 5-10.

23 ² Interim Relief Request, p. 17, l. 24-p. 18, l. 2.

24 ³ Front page headline; *Arizona Republic*, September 30, 2008.

⁴ APS Exhibits 7 and 8.

1 Thus, it was—at the time of the June filing—and remains today absolutely vital that the
2 Company protect its current, albeit very anemic, investment grade rating. As Mr. Brandt
3 testified, APS' ability to do that is in serious jeopardy:

4 APS faces the significant threat of a downgrade during the course of the
5 Company's rate proceeding because it does not have sufficient revenue to sustain
6 its FFO/Debt credit metric above investment-grade levels during the course of the
7 Company's general rate case, much less any financial cushion to protect it from
8 any financial difficulty that may occur during that time...[I]t remains true that—
9 for a company with the regulatory and other challenges facing APS—the
10 Company still must have an FFO/Debt ratio in the range of 18% to 20% in order
11 to avoid a downgrade to junk.⁵

12 APS FFO/Debt ratio will drop to 15.6% by the end of 2009, more than two full
13 percentage points below the 18% required to avoid a drop to junk. APS-6. Even taking into
14 account cash flow improvements caused by anticipated construction project delays, APS-22
15 shows that the key metric remains well within junk range and well below the 18% minimum at
16 next year's end—about the time a permanent rate decision could be expected.

17 **WORRIES INCREASE⁶**

18 However, as demonstrable as the need was for APS' interim relief in the weeks leading to
19 the hearing, the unprecedented economic developments immediately preceding, during and since
20 the hearing have amplified by several times the need to place APS on a stronger financial
21 footing. Events like the bankruptcy or emergency bailouts of major investment houses, \$85
22 billion in securitized government loans to AIG and the collapse of large thrifts and banks like
23 Washington Mutual and Wachovia have literally set the country's financial markets, rating
24 agencies and large and small investors on a razor's edge.

⁵ APS-2, p. 22, ll. 3-15.

⁶ Business Section Headline, *Arizona Republic*, September 30, 2008.

1 For example, on October 1, the Wall Street Journal ran a story, headlined "Turmoil in
2 Credit Markets Sends Jolt to Utility Sector." (Attached as Exhibit A.) Among other things, it
3 stated that credit market disruptions were already forcing utilities to either delay or come up with
4 new ways of raising cash.

5 Former Wisconsin Public Service Commission Chairman Charles Cicchetti, who has
6 spent more than three decades at, as he put it, the intersection of financial markets and
7 regulation, explained why these events have such a significant impact on APS and its need for
8 interim relief:

9 [A] wise person said that the Great Depression meant that people were concerned
10 not with the return on their investments, but the return of their investments. What
11 I think this past week has done is to make the return of invested capital seem
12 particularly risky....So the very thing that I think the market is concerned about
13 now, which is protecting principal, getting your investment back, raises the
14 problem that is sometimes called the attrition problem here or the regulatory lag
15 problem here....Add to that the fact that what you have is the credit rating
16 agencies being in a sense accused of not doing their job by predicting things soon
17 enough so that investors might have either avoided investment or gotten their
18 capital out... Those credit rating agencies, I think, are going to be on a very sort of
19 hair pull trigger that will make them more likely than they were a week ago to put
20 out the news of a downgrade or a threat sooner rather than later. And those two
21 things together...make it in my mind, a certainty that without some positive news
22 coming out of this interim case, that APS will, in fact, be downgraded.⁷

23 At hearing, Dr. Cicchetti was not alone in expressing concern about the elevated peril
24 faced by the Company. Staff witness David Parcel stated as a major uncertainty the "impact of
the current financial crisis on APS rating prospects." He also said he could not directly answer
the question of whether APS faces a substantial risk of downgrade.⁸ RUCO Director Stephen
Ahearn agreed that, while it was difficult to make sense of what was happening, the risk of a

⁷ HR TR, Vol. IV, p. 821, l. 24-p. 823, l. 17. (Emphasis supplied.)

⁸ HR TR, p. 895, ll. 19-20 and p. 897, ll. 12-16.

1 downgrade for APS had become—given current credit market developments—much more
2 dynamic.⁹

3 America remains financially strong and the United States' economy is remarkably
4 resilient. Although this situation may be more pervasive than prior economic reversals, the AIC
5 has no doubt that the country will successfully work through the current financial disruption just
6 as it has navigated through others numerous times before.

7 But, what this crisis has underlined is the critical need to make sure Arizona's power
8 needs and electricity fate is not left in the hands of others, including ratings agencies. This credit
9 convulsion has punctuated the absolute necessity of getting APS out of BBB- ratings territory,
10 off the first step of the basement stairs and safely away from the threshold of a junk bond rating.
11 An absolutely vital first step in doing these things is approval of this Interim Relief Request.

12 **I. The Evidence Supports the Need for and the Importance of Granting the**
13 **Company's Interim Rate Request.**

14 The record fully supports APS' need for \$115 million in interim rate relief. In fact, the
15 \$115 million request is quite conservative. As APS-9 indicates, more than \$166 million in
16 interim relief would be required to allow APS to achieve an FFO/Debt ratio of only 18.25%—
17 just a quarter point above the junk threshold—at year end 2009.

18 The parties agree that a downgrade to junk would, at the risk of severe understatement, be
19 “very bad” for the Company and its customers.¹⁰ Similarly, there is general agreement that the
20 effects of a downgrade would be substantial and long-lasting. Mr. Higgins testified that an APS
21 downgrade to junk would drive higher utility costs and corresponding negative impacts for

22 _____
23 ⁹ HR TR, Vol. V, pp. 1065-1066.

24 ¹⁰ See, for example, Ahearn testimony, HR TR, Vol. V, p. 1064, and Staff witness Smith's direct testimony (S-1) at p. 25.

1 customers.¹¹ Dr. Cicchetti offered the math that, given today's 107 basis point spread between
2 borrowing costs at APS' current grade of BBB- and the next "into junk" level of BB+, the result
3 is \$650 million in increased consumer costs for each \$1 billion of 30-year borrowing.¹² In other
4 words, consumer costs will be driven \$1.3 billion dollars higher as a result of just the \$2 billion
5 the Company needs to finance necessary facilities in the next five years if the Company's credit
6 rating drops further.¹³

7 But, the impacts of the drop to junk are not just higher costs. In light of the current credit
8 crisis, needed funds may simply not be available at any cost. Mr. Post pointed out that, even at
9 one step above non-investment grade—much less in non-investment grade territory--APS cannot
10 finance, or even plan, necessary large-scale solar, clean coal or nuclear facilities:

11 Here is the situation we face today from a financial standpoint. The Judge
12 yesterday questioned Don Brandt as to whether or not we are currently pursuing
13 [a] nuclear option. In our resource plan, we have 400 megawatts of new nuclear
14 coming on line in 2020 as the projection. That is only 12 years from now....
Because we can't finance one today, it impairs our ability to even pursue that
option.¹⁴

15 Mr. Brandt summarized the impacts as follows: "a downgrade to junk will have an immediate
16 and acutely adverse effect on the Company and its customers in terms of severely restricted
17 access to financing, dramatically increased financing costs, and decreased operational
18 flexibility."¹⁵

19 Staff and RUCO have recommended against the grant of interim relief. Mr. Ahearn's
20 filed opposition was premised primarily on his belief that APS' circumstances have not changed
21

22 ¹¹ AECC-1, p. 4, ll. 11-13.

¹² HR TR, p. 825, l. 14-p. 827, l. 15.

¹³ Assuming 30-year debt financing of that amount.

¹⁴ HR TR, Vol. IV, p. 710, l. 19-p. 711, l. 5.

¹⁵ APS-1, p. 3, l. 24-p. 4, l. 1.

1 significantly since the Company's fuel related interim request in 2006 was denied by the
2 Commission as an "emergency."¹⁶

3 What that position overlooks, however, is the fact that the Commission did grant over
4 \$100 million of fuel surcharge relief in Decision No. 68685. The Commission thus relieved that
5 pending threat two years ago in a different, but equally acceptable way. That is a far cry from
6 failing to take action at all. RUCO's status quo stance also ignores the facts that APS' FFO/Debt
7 metrics are trending down; absent interim relief nothing will change that; and that trend will
8 result in a below investment grade metric by year-end 2009.¹⁷

9 Staff's position is premised in part on Mr. Parcell's reference to the fact that all three
10 ratings agencies currently have "stable" outlooks for APS.¹⁸ However, S&P's stable outlook for
11 APS, which is quoted at page 12 of Mr. Parcel's testimony, contains the following, quite explicit
12 warning:

13 [C]onsolidated financial performance will continue to be challenged by
14 regulatory lag at APS, which could be moderated by APS' pending interim rate
15 request...Ratings could be lowered to speculative grade if the company is not able
to overcome the challenge of ensuring timely recovery of its prudently incurred
costs through rate increases approved by the ACC. (Emphasis supplied.)

16 Further, Mr. Parcel's reliance upon rating agency "stable" outlooks falls neatly into the
17 category of "those who ignore history are doomed to repeat it." On December 16, 2005,
18 S&P issued its report which confirmed both its triple B rating and specifically its "stable"
19 outlook on APS.¹⁹ Only five days later and with no intervening adverse regulatory or

22 ¹⁶ RUCO-4, p. 6, ll. 1-19.

23 ¹⁷ APS-6 and APS-22.

24 ¹⁸ Staff-2, pp. 10-12.

¹⁹ APS-15.

1 financial developments, S&P abruptly downgraded APS to BBB-, only one step above
2 investment grade.²⁰

3 The rating facts are as follows: Exhibit S-4 contains three S&P, Moody's and Fitch
4 reports which have been issued this year. On January 23, 2008, Fitch stated that attrition "due to
5 regulatory lag could lead to significant deterioration in...cash flows, resulting in credit
6 downgrades." On June 25, 2008, shortly after this filing was made, S&P's referenced the
7 impacts of regulatory lag and stated that ratings "could be lowered to speculative [junk] grade."
8 Finally, on July 28, 2008—only slightly more than two months ago—Moody's warned that a
9 "downgrade could result if Moody's expects a sustained weakening of financial metrics..." and
10 pointed to the FFO/Debt metric as its specific example.

11 This record fully supports and the Commission should grant APS' request for \$115
12 million in interim rate relief.

13 **II. The Commission Has Full Power To, and These Circumstances Fully Justify, the**
14 **Grant of Interim Relief.**

15 Article 15, Sec. 3 of the Arizona Constitution states as follows:

16 The Corporation Commission shall have full power to, and shall,
17 prescribe...just and reasonable rates and charges to be made and collected, by
public service corporations within the State for service rendered therein....

18 The ability to grant interim rate relief to APS is essentially an authority "sub-set" of the
19 Commission's broader "full power" to prescribe rates and charges.

20 The California Public Utilities Commission described this concept as follows:

21 Certain of the interested parties appearing in this proceeding have
22 questioned the jurisdiction and authority of this Commission to grant an interim
23 rate increase. The argument in support of this position is that there is nothing
specific in the Public Utilities Act that authorizes the grant by the Commission of

24 ²⁰ APS-16.

1 that type of rate relief. It is an elementary rule of law that the power to grant a
2 particular relief carries with it all the incidental, necessary, and reasonable
3 authority to grant that which is less. It is apparent that the authority...to award
rate relief to a public utility carries with it the incidental and implied power to
grant interim rate relief, if the facts warrant such summary relief.²¹

4 There is no doubt that this Commission—particularly given its broad grant of "full" power in
5 Arizona's Constitution—has all necessary "lesser" authority to grant interim rate relief. Instead,
6 the debate normally centers on the last issue stated by the California PUC, i.e. "if the facts
7 warrant such summary relief." Here the facts fully warrant Commission action.

8 In Arizona Corporation Comm'n v. Mountain States Telephone & Telegraph Co., 71
9 Ariz. 404, 408, 228 P.2d 749 (1951), the inability to grant relief in a reasonable time, as is the
10 case here, led Arizona's Supreme Court to authorize Mountain Bell to establish interim rates.
11 Obviously, the procedural situation in that matter was markedly different (this Commission is not
12 failing or refusing to act as that Commission was). But, the basic proposition established by the
13 Supreme Court has equal application here. Given the Company's deteriorating financial
14 condition; the downward trend line on its key FFO/Debt credit metric; the fact that the FFO/Debt
15 ratio will drop below investment grade status before the Commission can grant permanent relief;
16 and the explicit warnings of the rating agencies as to the likelihood of a junk rating, the
17 Commission has a complete set of facts which fully justifies interim relief.

18 The Commission also has quite recently confirmed that it has the power to act in fact
19 situations such as this which require interim support to protect both the Company and its
20 consumers. "We agree with Staff that our authority to determine emergencies is not limited to
21
22

23 ²¹ Re The Pacific Tel. & Tel. Co., 78 P.U.R. (N.S.) 491, 493 (1949); quoted with approval in Arizona Attorney
24 General Opinion No. 71-17.

1 specific, narrowly tailored facts, and that our ratemaking authority is sufficiently broad to enable
2 us to grant relief tailored to many different situations."²²

3 Similarly, the Commission has in the past granted APS interim relief in circumstances
4 precisely identical to these and to expressly protect the Company's credit rating. As Mr. Post
5 pointed out at page 8 of his rebuttal testimony (APS-11):

6 When APS was last granted non-fuel interim base rate relief, it was 1984
7 and the concern then expressed by the Commission was that APS might fall from
8 BBB+ to BBB, which in turn would jeopardize its ability to finance Palo Verde.

9 The order referenced by Mr. Post was Decision No. 53909 dated January 30, 1984. It was one of
10 six interim rate decisions issued by this Commission from 1975 to 1986 to support APS in the
11 last large construction budget and pronounced regulatory lag and attrition period of the 1970's
12 and 1980's.²³

13 Finally, Attorney General Opinion No. 71-17, which has been cited with approval in
14 several Arizona appellate decisions, specifically confirms the Commission's ability to approve
15 interim rate requests in a variety of factual circumstances including this one. Although it
16 discusses specific emergency examples which would warrant interim action, it concludes broadly
17 as follows:

18 Perhaps the only valid generalization on this subject is that interim rate
19 relief is not proper merely because a company's rate of return has, over a period
20 of time, deteriorated to the point that it is unreasonably low. In other words,
21 interim rate relief should not be made available to enable a public service
22 corporation to ignore its obligations to be aware of its earnings position at all
23 times and to make timely application for rate relief, thus preserving its ability to
24 render adequate service and to pay a reasonable return to its investors.

²² Decision No. 68685 at p. 23 (May 5, 2006).

²³ HR TR, Vol. IV, pp. 798-799.


1 There is absolutely no question that APS has been very diligent in timely seeking regulatory
2 relief in order to preserve its ability to provide service to Arizona and to attempt to pay its
3 investors a reasonable return.

4 **CONCLUSION**

5 These are exceptionally perilous times. Even absent the current credit crisis, the
6 challenges facing Arizona utilities including APS in raising sufficient amounts of debt and equity
7 capital at a reasonable cost in order to meet the rapid growth demands of our state are daunting.
8 Given the credit crisis, APS' "just barely" investment grade rating, poor stock price performance,
9 persistent under-earnings and declining credit metrics fully support its absolutely critical need for
10 \$115 million of interim relief.

11 RESPECTFULLY SUBMITTED this 3rd day of October, 2008.

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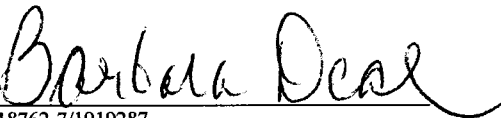
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EXHIBIT A

Turmoil in Credit Markets Sends Jolt to Utility Sector

BY REBECCA SMITH

Disruptions in credit markets are jolting the capital-hungry utility sector, forcing companies to delay new borrowing or to come up with different—and often more costly—ways of raising cash.

On Tuesday, for example, Duke Energy Inc. said “uncertain market conditions” compelled it to draw down \$1 billion from a \$3.2 billion master credit facility so it could have more cash on hand.

Globally, the volume of bond issuances by electric, gas and water utilities dropped drastically in the third quarter versus the prior quarter, to \$37.4 billion from \$62.2 billion, according to research firm Dealogic. In the U.S., it dropped by half, to \$9.66 billion from \$20.1 billion, third quarter over second quarter. Year-over-year, Dealogic said, the dollar volume dropped 2.6% globally in the third quarter of 2008 versus the same quarter in 2007 and 24.4% for the U.S. alone.

The drop in borrowing is significant because the utility sec-

tor is the third-greatest borrower after government and the finance sector. Utilities and other energy companies rely on debt markets to provide billions of dollars of funding for costly projects, such as the construction of power plants or transmission lines, as well as for general corporate needs.

Historically regarded as a safe-haven investment for widows and orphans, the sector has grown unpredictable due to industry deregulation, fuel-price volatility and, now, fluctuations in credit markets.

Most companies are still able to meet their daily cash needs by issuing bonds, selling stock or commercial paper, or by tapping credit lines. While that gives utilities some financial flexibility in the short run, it could be difficult to maintain if the tightness in the credit markets persists. Bonds eventually must be repaid and most firms must roll over debt, even if rates are high or if they are forced to accept unsavory debt covenants or conditions to appease bond purchasers. Higher costs either pinch shareholders or are passed on to customers.